

# World-Generation

Nov/Dec 2002 Volume 14

## Energy Opportunities in Challenging Times

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In conversations taking place from boardrooms to local coffee shops, we all seem to agree that the power generation business is undergoing extremely difficult times. Corporations have been laying off employees, closing operations, defaulting on loan covenants, and writing down assets. It doesn't stop there. Power prices have been low and frequently returns are below fixed costs. Substantial generating overcapacity is expected to exist in the general market for the next few years. Debt levels are high and mini perm financings are coming due. Energy companies' stock prices are severely depressed and bond ratings on their corporate paper have been dropping. In short, the general market is one of the most difficult in recent memory and merchant energy companies, banks and investors are very concerned about their investments in the power business.

As an industry, we need to calmly move forward to develop the opportunities that exist in this new business environment and begin to restore lender and investor confidence. This will take conservative judgment, creative thinking, patience, and perhaps radically innovative approaches.

### Energy Consolidations

Probably the largest restructuring opportunity existing at this time is at the corporate level in the form of mergers and acquisitions between energy companies. Given the large debt levels and liquidity constraints, it is likely that large diversified energy companies (traditional utilities) with strong balance sheets may acquire both strategic assets and companies. Unless power prices increase dramatically, a massive consolidation of energy companies is likely to occur. In theory, acquisitions of ailing companies by stronger companies are expected to improve the industry and the fortunes of ailing company stakeholders.

Congress is considering PUHCA reform. This legislation has limited the ability of non-utility players including foreign companies and oil companies to enter the power business. With the Republican-controlled Congress apparently supportive of PUHCA reform, it is likely that one of the largest barriers to M&A in the energy business will be removed. This action could lead to dramatic business restructuring throughout the industry. However, energy legislation will likely not pass until 2003 or later.

While FERC and SEC oversight may limit the widespread acquisition of ailing energy companies, a strong movement toward more industry concentration is likely. The number of investor owned utilities might shrink from the 140 or so existing today to several dozen within the next 5 years. This concentration will strengthen surviving companies.

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Regulated assets in this difficult environment are, of course, the most protected. These assets will continue to perform adequately and provide comfort to their investors. These assets include transmission and distribution companies, pipelines, regulated retail services and regulated generation. Since we have a patchwork of regulatory frameworks, the firms that have earnings protection from regulated operations have substantial strength under current market conditions. These are the firms that are likely to use their strength to acquire other companies that are a good business fit.

## **Restructuring Opportunities and Dilemmas**

A recent Standard and Poor's report stated that \$90 billion in debt is scheduled to be refinanced over the next 4 years. Many banks, including Citigroup, J.P. Morgan Chase, Bank of America, Deutsche Bank, Credit Suisse Group and others, hold significant power generation debt. These lenders and others are faced with accepting new loan terms, including interest only payments, calling loans and declining additional financings, extracting additional collateral where possible, and possibly putting companies into bankruptcy with their requirements. These difficult choices are not just faced by individual banks on individual deals, but are faced in large banking syndicates with multiple companies, including Calpine, Reliant Resources, Mirant, PG&E National Energy Group, NRG Energy and others. This structure adds to the complexity of the situation.

The overall business situation in the power generation area has become bad enough that in many cases the equity has been eroded significantly, leaving the banks exposed for losses. These losses could be substantial. Therefore, the power generation industry has gotten to a point where the lenders are basically in charge. While lenders are particularly concerned about running the business and acting like equity due to liability issues, they are in fact holding the cards.

With all of the bad news, many decision makers may feel that their choices are very limited. This may or may not be true, depending on the circumstances. First, the general market conditions are not as easy to predict as some would lead us to believe. In fact, the industry as a whole has had a poor track record over past decades in predicting generation requirements, oversupply conditions and market needs. Why should now be any different than the past?

Exhibit 1 shows the projected supply and demand balance based on NERC and DOE EIA information, and some comparative analysis. One can see that there are three different supply curves. The middle line assumes that no new generation will be built beyond that already under construction, while the top line assumes that some additional projects from those that have been announced will ultimately be built. The lower line is an estimated resource balance based on NERC's peak demand forecast and the generating capacity forecast from DOE/EIA's Annual Energy Outlook 2002.

The mid case of Exhibit 1 shows that based on current supply resources and demand expectations, we will have overcapacity (greater than a 15% reserve margin) until 2004-2005. After this time, there will be a general working off of excess capacity. This implies

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that if lenders can wait for 3 years, they may be operating in an environment where generation companies will recover fixed costs.

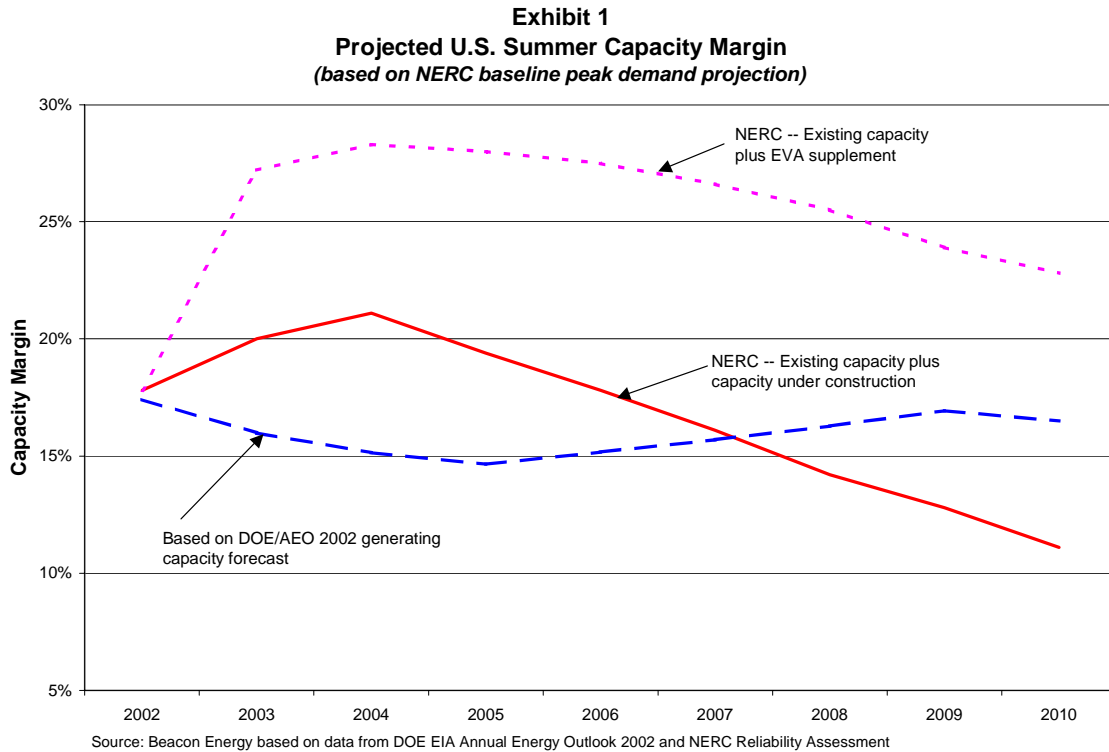


Exhibit 2 demonstrates that demand and supply assumptions have a substantial range. Using possible demand variations and supply variations including weather effects, project cancellations, and economic growth, the range of possible over or under supply varies from a 5% reserve margin in 2005 to a 30+% reserve margin in 2005. With a 5% reserve margin, generators are likely to recover substantial funds. Conversely, a high reserve margin may mean little to no fixed cost recovery. Accurately predicting the market timing could mean a lot to lenders with massive exposures. Having patience in difficult times, as long as conditions ultimately improve, could have very positive effects (results) for the banks. Of course, there are risk/reward trade-offs to juggle as well.

In addition to general trends, specific market conditions and transmission constraints can also materially change the outlook for specific assets. For example, New York City and Long Island are load pockets that can use additional generation. Other selected areas could benefit from additional generation or the sale of generation equipment originally destined for another market. To illustrate the differences between regions, Exhibit 3 shows selected forward curve prices in multiple regions. In some regions, the current forward pricing is adequate to make a contribution to fixed costs and meet base level economic return on investment criteria for new investments.

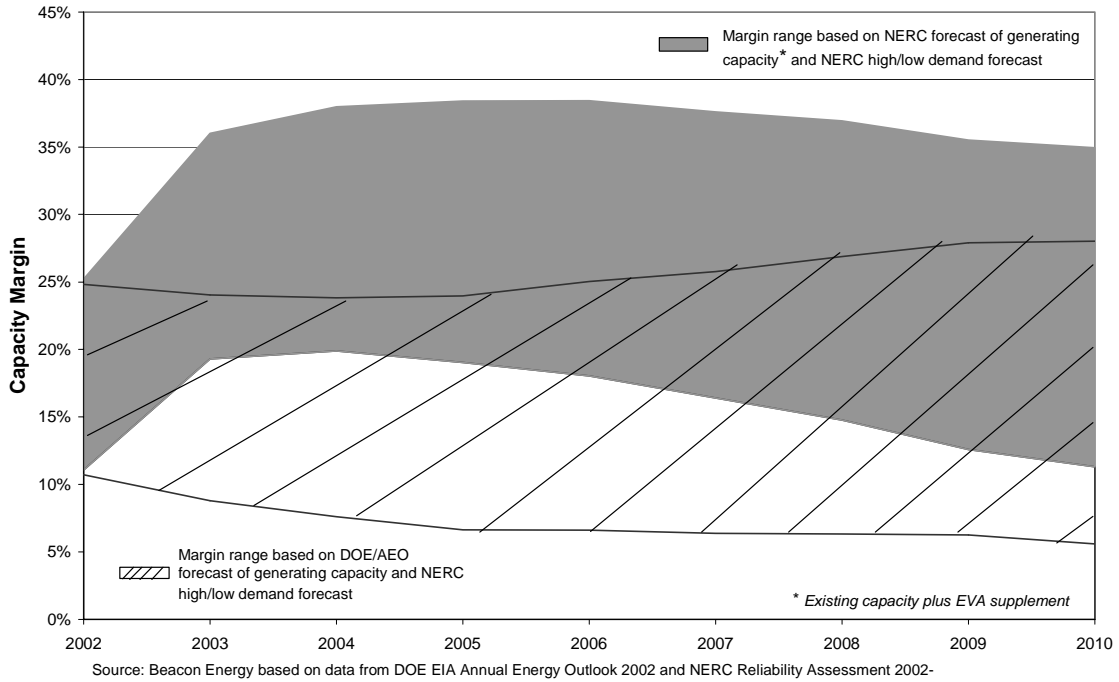
Some restructuring opportunities also exist in revising project contracts. It may be possible to increase the sales to load serving entities—regulated investor-owned utilities serving retail loads or public power entities. In other cases, new arrangements with fuel suppliers may be possible to transfer some long-term risk to additional counterparties. In

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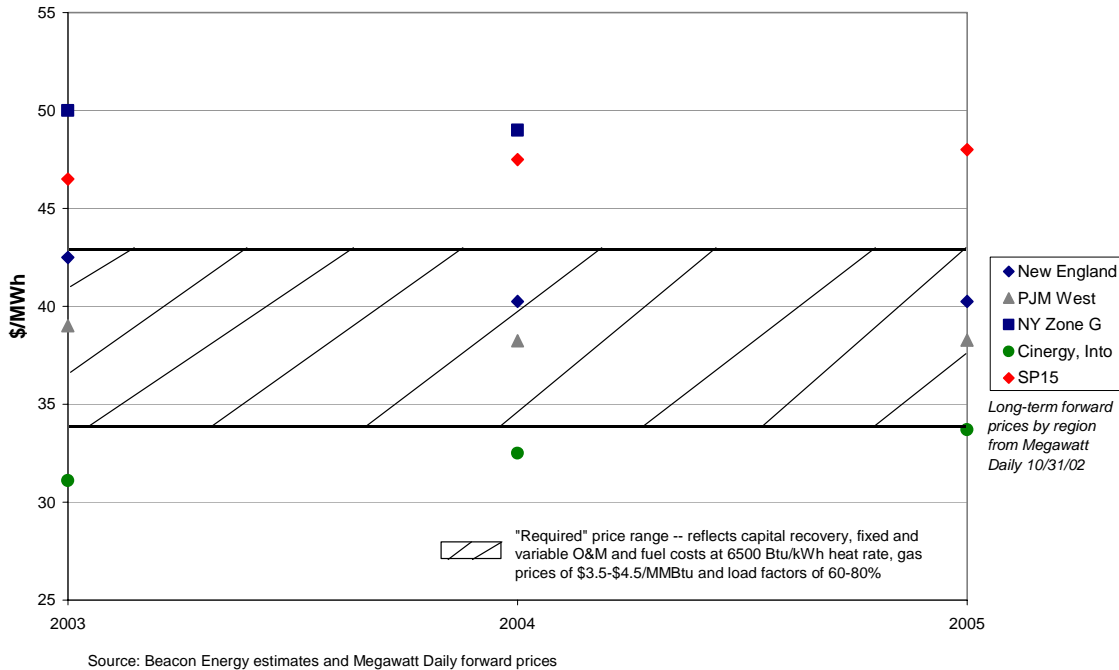
other cases, financial restructuring might help. Still, there are many projects where no apparent restructuring will save the day. The question then may be -- does the credit committee have the patience to wait for a recovery of the market, and again, how long is that likely to take?

Over time, transmission constraints and well-located projects will command a premium

**Exhibit 2**  
**Future Capacity Requirements Tied to Demand Uncertainty**



**Exhibit 3**  
**Current Forward Prices vs. "Required" Pricing**



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for their locational value. This value might help in the recovery of fixed costs. Ancillary services markets are gradually maturing and additional plant revenues may be achieved through bidding into ISO run ancillary services markets.

New financial structures might be designed that help mitigate lender risks. In exchange for interest only payments for three years for troubled projects, commercial lenders will receive more of the upside potential from projects and perhaps pooling and risk diversification can be applied to portfolios.

Equity holders may look at selling existing equipment planned for existing or future projects. Under today's market conditions, the current value of equipment may be of higher value than the site and fully developed project. It may be possible to liquidate the equipment and recover more of the investment than simply walking away from the asset and viewing the investment as a sunk cost. It may also be possible to improve the value of the asset by changing equipment, better utilizing existing infrastructure, and other techniques. A creative approach to individual assets may yield improvements of returns.

From a corporate perspective, it may make sense to diversify generation sources to include some new coal projects, renewable projects (most likely wind) and distributed generation. A more balanced portfolio might help improve returns and assist in risk mitigation. Lenders may be able to trade out positions with other lenders.

Based on a consensus view of the world, the timeframe for improving market conditions and the recovery of the non-regulated generation sector may be in 2005. A cold winter, the current reduction in gas production by 6-9% among many gas companies, and/or the reduced rig count in 2002 may add price volatility to both natural gas and power prices. A recent review of spark spreads in 2002 versus 2001 shows a growing spread in some markets. Weather variations can assist in improving margins. Energy markets follow cycles that are difficult to predict. Opportunities are found by careful analysis, patience and dogged determination.

## **Re-establishing Investor Confidence in the Generation Business**

Without the confidence that business conditions will improve, the world becomes a scary place. In such an environment, debt and equity re-structuring decisions are extremely difficult, if not impossible, to make. More companies are driven to sell assets than are interested in buying assets. Companies pull back from making the right decisions, and individuals tend to worry more about avoiding risks and keeping their jobs rather than making the right decision and accepting the chance of any negative consequences. Firms used to be interested in profitable opportunities – now they seem to be obsessed with avoiding risk.

Yet, investor confidence can and will be re-established in the business. Residential, commercial and industrial customers still have a fundamentally solid and growing demand for electricity. Gradually, company liquidity issues will improve, power prices will improve, balance sheets will strengthen, and investors will see stock appreciation. Groups such as the Committee of CRO's (Corporate Risk Officers) comprised of participating companies such as AEP, Cinergy, Constellation, Duke, Tractebel, and TXU

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will help set common standards, practices, and disclosures. It will take a certain amount of time as well as the perseverance and leadership of key people in the energy generation business. It will also not happen overnight.

The generation business is a cyclical business that will follow its own natural cycle. The key will be adapting to the changing business environment and searching for the right opportunities. After careful analysis, companies, lenders and investors that back fundamentally sound positions and have the patience to weather the downturn are likely to prosper. Massive write-offs or reacting quickly to market analysis hype—good or bad, will likely lead to poor financial results.